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TREASURY FOR NANCY LEE, ALICE FAIBISHENKO
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US SOUTHCOM FOR POLAD

E.O. 12958: N/A
TAGS: ECON EFIN EINV AR
SUBJECT: A SURPLUS 2007 BUDGET DESIGNED TO BOLSTER KIRCHNER ADMINISTRATION'S RE-ELECTION BID


Summary
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¶1. (SBU) The Argentine Senate approved the 2007 National Budget December 13, 2006, in the face of opposition criticism over its growth and inflation assumptions, the continuation of "superpowers" that allow the GoA to make future fiscal decisions without Congressional authorization, and the lack of transparency in disbursement of subsidy payments. The Budget estimates federal revenues at ARP 128.5 billion (approx. $41.5 billion or 18% of GDP), and expenditures are forecast at ARP 121.3 billion (approx. $39.1 billion or 17% of GDP), achieving an overall balance of 1% of GDP and primary fiscal surplus of 3.03% of GDP. The Kirchner administration has tailored the 2007 Budget to help it win the October 2007 presidential elections. The Budget underestimates resources, envisions a significant increase in social expenditures, and considers GoA refinancing of provincial debt, all of which should win Kirchner votes. End Summary.


Senate Passes 2007 Budget Bill Into Law
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¶2. (SBU) The GoA sent its fiscal year 2007 (which corresponds to the calendar year) Budget bill to Congress September 15 as required by the Constitution, and Minister of Economy Felisa Miceli presented it to the Chamber of Deputies for its approval on September 26. The Chamber passed the bill November 23 (with 143 votes in favor, 77 against, 6 abstentions), and the Senate approved it without modification on December 13 (with 41 votes in favor and 22 against).

¶3. (SBU) During debate in both houses, the opposition criticized the budget for underestimating both GDP growth and revenue prospects, setting the stage for the GoA to use surplus tax revenues to finance discretionary pre-election social policy and targeted infrastructure development expenditures. They also criticized the so-called "Superpowers" Law, which allows the GoA to make subsequent changes to the budget without prior Congressional approval. The opposition also expressed concern over increasing subsidies, mainly to the energy and transportation sectors,

and criticized the lack of transparency in the disbursement of such funds. (Note: Congress approved the "superpowers" law August 2 as an amendment to the existing Financial Administrative Law. The amendment gives te GoA the legal ability to modify the Budget Law and reallocate funds regardless of the provisions of the Financial Administrative Law or the Fiscal Responsibility Law, and without consulting Congress. Although opposition parties are seeking to repeal the "superpowers," the GoA's majority support in the House and Senate makes this unlikely. End Note).

## Conservative Macroeconomic Assumptions

¶4. (SBU) The Budget's macroeconomic assumptions are conservative compared to private analysts' economic forecasts, as measured in the central bank's (BCRA's) consensus survey from September. GDP is forecast to increase only 4% in 2007, well below the current BCRA consensus forecast of 6.3%. The Kirchner administration has used this strategy of underestimating growth in past budgets -- underestimating revenues by ARP 19 billion (31% of total revenues) in 2004, ARP 11 billion (13% of total revenues) in 2005, and ARP 14 billion (14% of total revenues) in 2006 -- and it allows the administration to spend excess revenues at the end of the year with only perfunctory Congressional approval (Note: The Kirchner administration's solid majority support in both houses of Congress makes Congressional approval a sure thing. End Note).

¶5. (SBU) As in previous years, the opposition in both houses harshly criticized the growth assumption, claiming it underestimates revenues by ARP 8 - 12 billion (approx. $2.6 - 3.9 billion, or 6-9% of total revenue). However, Minister Miceli has publicly defended budget assumptions, arguing (in a reference to a succession of budget deficits in the 1990s that required the GoA to increase its borrowing in international capital markets), that, "generating expectations for revenues that the GoA cannot fulfill would be a return to the past." She further explained that the GoA will prioritize spending of any higher than projected revenues on education, retirement benefits, and higher wages for state employees.

¶6. (SBU) The Budget also lowballs other assumptions. It estimates CPI inflation at 7.7%, compared to the BCRA consensus survey forecast of 10.5%. It assumes an average nominal exchange rate of 3.13 ARP/USD, compared to the BCRA consensus survey of 3.20 and the 2006 Budget assumption of 3.09. It forecasts export growth of 7.8% and import growth of 10.7% in 2007 (in real terms), resulting in an $8.1 billion trade surplus ) substantially below the BCRA's $9.6 billion consensus forecast. Finally, the budget forecasts investment growth of 7.2%, compared to the BCRA consensus forecast of 13%, with total investment in 2007 reaching 23.3% of GDP. The budget forecasts nominal GDP to reach ARP 694 billion (approximately $224 billion) by the end of 2007.

## Macroeconomic Assumptions For 2007

| | Budget | Market Expectations |
|---|---|---|
| GDP (real growth) | 4.0 | 6.3 |
| Consumption (real growth) | 3.3 | 5.9 |
| Investment (real growth) | 7.2 | 13.0 |
| Exports (USD in billions) | 52.6 | 48.3 |
| Imports (USD in billions) | 44.4 | 38.7 |
| Inflation (average) | 7.7 | 10.5 |
| Nominal Exchange Rate (average) | 3.13 | 3.20 |

## Revenues: Increase Driven By Economic Activity

¶7. (SBU) Federal revenues are estimated at ARP 128.5 billion (approx. $41.5 billion or a 16% nominal and 9% real increase over 2006), equivalent to 18% of GDP. Tax revenues account for 74% of federal revenues, social security contributions for 20%, and non-fiscal revenues, mainly financial profits from GoA financial investments, revenues from the sales of GoA machinery and real estate, and BCRA profits, total ARP 7 billion ($2.26 billion or 5% of total revenues). The fiscal burden (total tax collection and social security contributions) will reach 17.5% of GDP in 2007, compared to 16.8% in 2006.

¶8. (SBU) The Budget estimates total tax revenue at ARP 95.3 billion (approx. $30.7 billion), an increase of 13% in nominal terms and 6% in real terms over 2006 (Note: this calculation uses the GoA's 2007 7.7% CPI inflation target. End Note). This forecast is based on expected nominal price increases, and strong economic activity, employment, and trade, as well as an improvement in tax compliance. The highest increases are: import taxes ( 15.4%), export taxes ( 14.4%), financial transactions tax ( 13.9%), and income tax ( 12.7%).

¶9. (SBU) Tax revenues account for 64% of the increase in total revenue. Social Security contributions comprise 28% of the increase in revenue, and are estimated at ARP 26 billion (approx. $8.4 billion; a 24% nominal and 16% real increase versus 2006). This is due to the expected increase in nominal salaries as well as an increase in the number of contributors.

¶10. (SBU) The GoA's 2007 budget does not envision changing tax regulation, unlike in previous years when it considered the elimination or phase-out of the export and financial transactions (FTT) taxes. The IMF -- supported by many in the opposition -- has consistently advocated the elimination of both taxes, which represent 28% of fiscal revenue, due to their distortive impact. However, the Kirchner

administration's congressional majority has refused to support a reduction of either tax, since that would eliminate the GoA's primary fiscal surplus. (Note: Export tax revenues reached ARP 12 billion and FTT ARP 9.3 billion during the first ten months of 2006, and the primary fiscal surplus reached ARP 21.2 billion, or 3.5% of GDP on an annualized basis. 100% of export tax revenues and 70% of FTT revenues are not subject to co-participation with the Provinces, offering the Kirchner administration added political leverage in the allocation/distribution of such revenues. On November 15, Congress approved the extension of the FTT through the end of 2007. End Note).

Expenditures: Increase Driven By Social Expenditures
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¶11. (SBU) The GoA budgets 2007 expenditures at ARP 121.3 billion ($39.1 billion, or a 15% nominal and 8% real increase over 2006), equivalent to 17% of GDP. The GoA prioritizes expenditures on social security, education, science and technology, and economic and social infrastructure with the overall goal of generating improved income distribution.

¶12. (SBU) The highest year-over-year increase is spending on social services -- ARP 78 billion (approx. $25 billion, or an 18% nominal increase over 2006), equivalent to 11% of GDP and 64% of total expenditures. This includes a 13% increase for pensions in 2007, on top of the 11% increase in 2006, and the 60% increase in unemployment benefits (up from ARP 250 to ARP 400 per month). The bill allows the GoA to increase pensions further in 2007, as long as excess funds are available. (Note: The Argentine Supreme Court mandated a minimum 13% pension increase in a 2006 ruling. End Note).

¶13. (SBU) Education, science and technology expenditures are forecast to increase ARP 1.6 billion (17% nominal) to ARP 10.7 billion. This increase is consistent with the GoA's Education Financing Law, which calls for annual federal (0.5%) and provincial (0.2%) spending increases through 2010

in order to bring total education expenditure to 6% of GDP.

¶14. (SBU) Infrastructure spending is comprised mainly (83%) of transportation (ARP 6.1 billion, or almost $2 billion) and energy (ARP 5.6 billion, or $1.8 billion) subsidies to the private sector, to keep energy and public transportation prices unchanged and control inflation. As noted above, the opposition and local press have criticized the government for the increases in such expenditures and also for the less than transparent way that such funds have been disbursed in the past.

¶15. (SBU) Interest payments are estimated to increase from ARP 12.7 billion to ARP 14.1 billion, or 2% of GDP in 2007. Interest payments on peso-denominated debt (including guaranteed loans, Bodens, Bocones, and restructured debt) are ARP 5 billion. Payments on foreign currency debt (USD Bodens, restructured debt, and payments to IFIs) are ARP 8.8 billion. (Note: In 2007, the GoA will pay approximately $650 million in interest on debt included in the 2005 sovereign debt exchange. Post roughly estimates that the GoA would have paid an additional $230 million/year to holdouts from the debt exchange, had they accepted the same deal in ¶2005. This debt represents a potential contingent liability if/when the GoA eventually reaches an accommodation with holdouts. End Note)

Fiscal Balance: Positive But Decreasing
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¶16. (SBU) The 2007 federal government primary fiscal surplus (revenues less expenditures, excluding interest and principal payments on debt) is forecasted at ARP 21 billion (approx. $6.8 billion) or 3.03% of GDP, close to the 2006 forecast of 3% included in the 2006 budget. The consolidated federal primary fiscal surplus - adding in fiduciary trusts and social security, but excluding provinces - is projected to fall to 3.15% of GDP from 3.26% in 2006. The projected overall balance for the consolidated federal government

totals ARP 7.1 billion (approx. $2.3 billion or 1% of GDP, compared to 1.15% in 2006).

¶17. (SBU) The Budget bill does not include a breakdown of individual provincial finances. However, it notes that the provincial primary fiscal balance will be "slightly positive." The consolidated public sector primary surplus, including provinces, will remain at 3.15% of GDP in 2007 under the budget's best case scenario that provinces have a neutral primary fiscal surplus. However, the consolidated public sector primary surplus (including provinces) would drop to 3.03% of GDP if the Provinces end 2007 with a 0.1%/GDP deficit, as most private consultants forecast. (Note: This expected provincial deficit is primarily due to Buenos Aires Province's projected deficit, which the province plans to finance partially via an international bond issuance and partially via borrowings from the federal government. End Note).

Financing: GoA Relying Primarily On New Debt Issuance
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¶18. (SBU) The GoA's 2007 financing needs total ARP 73 billion ($23.5 billion), including ARP 57 billion in debt amortization and ARP 16 billion in "financial investment" (i.e., lending to provinces for project and deficit finance). The GoA will finance these needs via:

- ARP 7.2 billion from the federal fiscal surplus;
- ARP 23.5 billion in new debt issuance;
- ARP 7.0 billion in IFI financing;
- ARP 20.4 billion in BCRA financing;
- ARP 9.0 billion domestic demand for GoA debt; and
- ARP 4.8 billion loan repayments (mainly from Provinces).

¶19. (SBU) Central Bank (BCRA) net financing totals ARP 2.1 billion as a result of ARP 20.4 billion financing and ARP 18.3 billion GoA repayment of short-term BCRA financing. The Budget assumes the IDB and World Bank will reduce their net

exposure, providing ARP 7 billion total financing, with scheduled GoA repayments of ARP 4.3 billion to the Bank and ARP 3.3 billion to the IDB.

Province Debt Renegotiation: Tool To Gain Political Support
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¶20. (SBU) The 2007 Budget allows the Ministry of Economy to modify (restructure) the financial conditions of provincial debt owed to the federal government, although it lacks details on the terms and conditions of the restructurings. This is a key provision for the GOA during an election year, as the Provinces are beginning to face financial difficulties and this is one way to gain their favor. According to local think tank, "Economia y Regiones," provincial debt available for restructuring totals ARP 6 billion (almost $2 billion, or 10% of total provincial debt to the GoA).

Comment
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¶21. (SBU) The 2007 Budget has clearly been designed to support the Kirchner administration's re-election bid next October. The positive (forecasted) fiscal balance and increased social expenditures, transfers, and subsidies to the private sector (in order to keep energy and transportation prices low and control inflation), all serve to win voter support for the GoA. The Budget's underestimation of GDP growth will likely result in ARP 8 - 12 billion extra revenue, and the "Superpowers" law will allow the GoA to use this available cash to target social and infrastructure expenditures to woo particular constituencies. End Comment.

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